CONSULTATION RESPONSE

US SECURITIES AND EXCHANGE COMMISSION: REOPENING OF COMMENT PERIOD FOR PAY VERSUS PERFORMANCE; RIN 3235-AL00

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INTRODUCTION

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has now over 4,700 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US$120 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

The PRI welcomes the opportunity to respond to the Securities and Exchange Commission's (SEC or "the Commission") call for feedback on proposed rules under the Dodd-Frank Act requiring disclosure of information reflecting the relationship between executive compensation actually paid by a company and the company's financial performance.

ABOUT THIS CONSULTATION

The PRI writes in support of the proposed rule amending Item 402 of Regulation S-K to implement Section 14(i) of the Securities Exchange Act of 1934 (the "Exchange Act"), as added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which requires registrants to disclose how the executive compensation paid by the registrant relates to the financial performance of the registrant over the time horizon of the disclosure.

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KEY RECOMMENDATIONS

The PRI supports the inclusion of additional disclosure proposed by the SEC, including:

- pre-tax net income;
- net income;
- a measure specific to a particular registrant, chosen by said registrant (the "Company-Selected Measure"); and,
- a list of the most important performance measures used by the registrant to link compensation actually paid during the fiscal year to company performance.

The proposed disclosure beyond Total Shareholder Return and Peer Group Total Shareholder return will provide additional information to investors on executive compensation and enhance comparability of issuer's disclosed information. This disclosure would allow investors to evaluate whether proportionate pay policies are in place and how executive pay stands in relation to value created.

The PRI welcomes the inclusion of a company-selected measure as well as the list of the five most important performance measures, as these additions would allow registrants the flexibility to show whether ESG performance measures significantly impact executive pay. Consideration of ESG factors is increasingly integrated across investment decision-making and investors' exercise of their fiduciary duties, including through issuer engagement. Issuers should communicate with investors on ESG-related factors they consider, and their relationship to executive compensation. The PRI recognizes that the link between ESG measures and executive pay requires scrutiny by investors to prevent pay padding or similar abuses. Appropriate disclosure of these links is important to providing effective investor and public scrutiny and consideration of compensation.

DETAILED RESPONSE

THE PRI'S POSITION ON EXECUTIVE PAY AND ESG

Linking ESG measures to Executive Pay

The PRI's work on ESG-linked pay has shown that significant gaps remain in company practice and disclosure that can exacerbate existing concerns about misalignment of incentives and performance.[1]

If structured appropriately and implemented effectively, ESG-linked pay can:

- increase firm value;
- rebalance the excessive emphasis on short-term performance targets in typical remuneration packages, which may run contrary to long-term financial and sustainability objectives; and,
- create better accountability on sustainability-related performance.[2]

The PRI recommends that investors adopt a formal position in favor of substantive links between ESG-related factors and pay, encourage investee companies to link ESG measures to executive pay and engage with companies that either do not consider ESG measures in their executive pay packages, or fail to do so in a meaningful way.[3] Further, the PRI has long called for better reporting by companies on ESG targets, performance against those targets and actual impact on pay.[4] Transparent reporting of these matters will allow investors to better determine whether pay policies are structured appropriately and what role ESG factors play in compensation actually paid.

One important issue for investors is determining how executive compensation aligns with the issuer's workforce, an issue that has come to the forefront during the Covid-19 pandemic. The proposed disclosure could prompt investor and company dialogue where potential misalignments exist between executive compensation, workforce needs and conditions, and financial performance.

Ensuring ESG measures are appropriate

Comprehensive and detailed disclosures of linkages between executive compensation and ESG factors are important for investors to ensure the integrity of compensation, and reduce risks of pay padding or other abuses. For example, vague ESG factors can add to the complexity of remuneration structures, and ESG targets that are too easily achievable may be used to inappropriately boost executive pay. Further, excessive focus on some ESG metrics could inappropriately hinder other sustainability objectives or lead to perverse, unintended consequences; for example, by discouraging

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[1] Principles for Responsible Investment, *Integrating ESG Issues Into Executive Pay*, available at https://www.unpri.org/governance-issues/integrating-esg-issues-into-executive-pay/556.article.
[2] Ibid.
[3] Principles for Responsible Investment, ESG linked pay: recommendations for investors (June 2021), available at https://www.unpri.org/executive-pay/esg-linked-pay-recommendations-for-investors/7864.article?adredir=1.
[4] Principles for Responsible Investment, *Integrating ESG Issues Into Executive Pay*, available at https://www.unpri.org/governance-issues/integrating-esg-issues-into-executive-pay/556.article.

accurate reporting and risk monitoring. The PRI encourages the Commission publish follow-on guidance on these matters once the proposed rule is finalized.

As not all relevant ESG factors can be easily quantified, boards may be forced to make certain trade-offs to reach the right balance of environmental, social and governance measures for the purpose of pay. Where issuers face challenges in identifying the right metrics or targets for certain ESG issues, they should endeavour to disclose these issues, as well as describe the process undertaken to provide investors and stakeholders the rationale. Over time, it is likely that challenge from investors and other stakeholders will improve the rigour and process that issuers employ to link ESG factors to pay. While there has been some improvement in this area, practices are often inconsistent across industries and issuers, and even within a single issuer over time. For example, some issuers may have greenhouse gas emission targets aligned with their executive pay, but these targets may not align with transition plans or a Paris-aligned climate scenario.[5] Identifying these types of inconsistencies for further scrutiny by investors and regulators should be a key objective for disclosures.

In order to prevent the abuse of ESG-linked pay, investors also have a role in holding issuers accountable, ensuring that selected ESG factors genuinely stimulate systematic progress towards sustainability ambitions, and do not reward executives for business as usual (e.g. maintaining compliance with laws and regulations) or for improving perceptions regarding sustainability performance (e.g. by tying pay to inclusion in sustainability indices, which are rarely specific to companies' ESG performance). Doing so, however, requires comprehensive, reliable, consistent, and comparable disclosure for investors to interpret and utilize in engagement and investment decision-making.

[5] Climate Action 100+, one of the largest investor initiatives on climate change, has placed demands on target companies in high-carbon industries to integrate ambitious climate metrics and goals in their executive remuneration packages: https://www.climateaction100.org/progress/net-zero-company-benchmark/.

THE PRI'S COMMENTS ON SPECIFIC ASPECTS OF THE PROPOSED RULE

The PRI supports the proposed additional disclosures as they provide investors with further information on executive compensation and enhance comparability of registrant's pay practices.

- **Pre-tax net income and net income**

The PRI supports requiring disclosure of pre-tax net income and net income. These metrics provide meaningful information to investors and will increase comparability of registrants' executive compensation practices. Further, since this information is already provided for under the Generally Accepted Accounting Principles (GAAP), the disclosure is straightforward.

- **"Company-Selected Measure," the most important performance measure used by the registrant to link compensation actually paid during the fiscal year to company performance**

The PRI supports requiring disclosure of a "company-selected measure" that forms a principal basis of consideration for the issuer's approach to executive compensation. Providing registrants with the option to list the most important measure not already included in the required disclosure will provide registrants with the flexibility to more accurately show how executive compensation is actually determined.

- **A tabular list of a registrant's five most important performance measures used to determine compensation actually paid**

The PRI supports requiring disclosure of the five most important performance measures, as it would allow issuers to show whether ESG-related measures play an important role in the determination of executive pay. Since many issuers outline key sustainability challenges in their sustainability reports and other publications, these disclosure requirements would allow investors to better understand the extent to which ESG issues are integrated into executive pay packages.

- **A clear description of the relationship among the measures provided in the tabular form. Registrants would be allowed to choose the format used to present the relationship, such as a graph or narrative description**

The PRI supports requiring a clear description of the relationship between the disclosed measures and executive compensation. This simple-to-understand approach would be particularly valuable to investors. In general, insights on the underlying methodology for calculating performance measures, their definition, and how progress on these performance metrics is measured are key for investor understanding of executive pay. Only with this information can investors fully evaluate whether pay is appropriately tied to performance. Allowing for a generalized disclosure from issuers presents challenges for investors in lacking consistency, perhaps across years, and comparability, across companies. The Commission should consider minimum required information for such disclosure or providing guidance on precisely what information should be included and how said information should be formatted. This approach could allow for greater flexibility in the requirements over time, as investors' interests and priorities evolve. The PRI consistently hears from its signatories around the world that a lack of consistent, comparable information is a primary barrier to their more fully understanding how issuers evaluate ESG information – which itself includes information about how executive compensation is determined.

To the extent that other ESG measures may be used to assess executive compensation, a narrative disclosure on the selection, definition, measurement and assessment of those measures is essential. A narrative discussion in addition to disclosed ESG measures linked to executive compensation can help investors understand whether ESG measures are appropriately selected, showing whether ESG measures are incorporated in a meaningful way, and how ESG measures are tied to business priorities.

The PRI has experience of public policy on sustainable finance policies and responsible investment across multiple markets and stands ready to further support the work of the Commission to require disclosure of information reflecting the relationship between executive compensation actually paid by a company and the company's financial performance in the United States.

Any question or comments can be sent to [redacted].